

REPORT OF EXAMINATION
SAFECO SURPLUS LINES INSURANCE COMPANY

Seattle, Washington

December 31, 2000

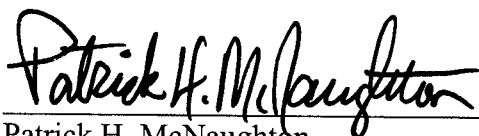


States Participating:

Washington
Delaware
Nevada

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify that I have reviewed the attached Report of Examination of the financial condition and affairs of SAFECO SURPLUS LINES INSURANCE COMPANY of Seattle, Washington, as of December 31, 2000.

A handwritten signature in black ink, reading "Patrick H. McNaughton". The signature is written in a cursive style with a horizontal line underneath it.

Patrick H. McNaughton
Chief Examiner

9-11-03

Date

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SALUTATION

Seattle, Washington
August 27, 2003

The Honorable Alfred W. Gross
Commissioner, Commonwealth of Virginia
Chair, NAIC Financial Condition (EX)
Committee
State Corporation Commission
Bureau of Insurance
PO Box 1157
Richmond, VA 23218

The Honorable John Morrison
Commissioner, Montana Department of
Insurance
NAIC Secretary, Western Zone
840 Helena Avenue
Helena, MT 59601

The Honorable Susan F. Cogswell
Commissioner, Connecticut Dept. of
Insurance
NAIC Secretary, Northeastern Zone
PO Box 816
Hartford, CT 06142-0816

Honorable Mike Kreidler
Commissioner, Washington State
Office of Insurance Commissioner
5000 Capitol Boulevard
PO Box 40255
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutory requirements of Chapter 48.03 of the Revised Code of Washington (RCW), an Association Examination was made of the corporate affairs and financial records of the

SAFECO SURPLUS LINES INSURANCE COMPANY of Seattle, Washington

hereinafter referred to as the Company, at its home office located at SAFECO Plaza, 4333 Brooklyn Avenue Northeast, Seattle, Washington 98185.

The Company's premium writings consisted of fire, allied lines, commercial multiple peril, inland marine, medical malpractice, earthquake, worker's compensation, other liability, burglary and theft and boiler and machinery on an excess and surplus lines basis only. The Company was admitted only in Washington and therefore, wrote excess and surplus lines of business in all states except Washington, as surplus lines business may be written only with non-admitted companies. Business written by the Company was ceded 100% to SAFECO Insurance Company of America, the Company's parent. A listing of the Company's affiliates and the Company's relationship as a member of an insurance company holding system is included in this Report of Examination under the caption "AFFILIATED COMPANIES". The Company was under the

control of and managed by a Board of Directors. Officers were appointed by the Board of Directors to operate the Company.

The last examination was as of December 31, 1995. The following Report of Examination is respectfully submitted showing the condition of the Company as of December 31, 2000.

SCOPE OF EXAMINATION

Per RCW 48.03.010, the examination covered the five-year period from January 1, 1996 through December 31, 2000. The Company was last examined as of December 31, 1995 by examiners representing Washington, Delaware and Ohio (General Interrogatory No 22 (d) of the Company's 2000 Annual Statement incorrectly reported that the last financial examination was made by the Washington, Louisiana, Vermont and Illinois Insurance Departments). On April 19, 2001, an Association Examination was called to begin on June 4, 2001. Insurance examiners from the states of Washington, Delaware and Nevada conducted the current examination concurrently with the Association Examination of five other companies domiciled in Washington – SAFECO Insurance Company of America, General Insurance Company of America, First National Insurance Company of America, SAFECO Life Insurance Company and SAFECO National Life Insurance Company. The Southeastern and Midwestern Zones of the National Association of Insurance Commissioners (NAIC) were invited to participate in the examination but elected to decline.

A December 31, 2000 examination of SAFECO National Insurance Company was conducted concurrently by the Missouri Insurance Department. December 31, 2000 examinations of SAFECO Insurance Company of Illinois and its subsidiary, Insurance Company of Illinois, were also conducted concurrently by the Illinois Insurance Department.

The examination of the Company was conducted in accordance with the laws of the state of Washington contained in Title 48 RCW and regulations contained in Title 284 Washington Administrative Code (WAC) and the examination procedures prescribed by the NAIC Financial Condition Examiner's Handbook.

Corporate records and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. Comments on any adverse findings that are applicable to the current examination are included in the "INSTRUCTIONS", "COMMENTS AND RECOMMENDATIONS" and "ACCOUNTS AND RECORDS" sections of this report.

INSTRUCTIONS

The examination disclosed the following issues that require Company action:

1. Insurer Holding Company Act Violation

SAFECO Asset Management Company (SAM), an affiliate acquired by SAFECO Corporation in 1973, serves as the investment advisor for the Company and its affiliates. Investment transactions were conducted between the Company and SAFECO Asset Management Company during the five year period under review for which no intercompany agreement was in force to define the rights and responsibilities and cost reimbursement methodologies.

These affiliate services performed by SAM are required to be “fair and reasonable” as to terms and charges pursuant to RCW 48.31B.030(1)(a)(i) and (ii). In addition, RCW 48.31B.030(1)(a) requires: “(iii) Expenses incurred and payment received must be allocated to the insurer in conformity with customary insurance accounting practices consistently applied; (iv) The books, accounts, and records of each party to such transactions must be so maintained as to clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties.”

The Company is instructed pursuant RCW 48.31B.030(1)(b)(iv) to submit for approval to the Washington State Office of Insurance Commissioner (OIC) an intercompany agreement with SAM and pertinent affiliates which complies with RCW 48.31B.030(1)(a).

2. Errors in Annual Statements

Review of the Company’s Annual Statements for the period under examination disclosed several errors and/or omissions. RCW 48.05.250(1) states, “Each authorized insurer shall annually, before the first day of March, file with the commissioner a true statement of its financial condition, transactions and affairs as of the thirty-first day of December preceding. The statement forms shall be in general form and context as approved by the National Association of Insurance Commissioners for the kinds of insurance to be reported upon, and as supplemented for additional information required by this code and by the commissioner.”

The Company is instructed to review and continue its efforts to substantially strengthen controls to comply with RCW 48.05.250(1) which requires the Company to file a true statement of its financial condition, transactions and affairs. The results of the examination disclosed the following errors in the Company’s Annual Statements:

- a) Schedule D, Part 4 of the Company’s 2000 Annual Statement reported “None” as the name of the purchaser of one of the two securities disposed of during the year. The Company indicated that “None” was an erroneous entry.

- b) Schedule D, Part 4 of the Company's 2000 Annual Statement reported figures brought forward from Schedule D, Part 5 of the same Annual Statement; however, the 2000 Annual Statement did not contain a Schedule D, Part 5.
- c) Purchases of bonds reported in the Company's 1996 through 2000 Annual Statements were selected and reviewed. Schedule D, Part 1 of the Company's 2000 Annual Statement did not reflect the call year and price reported on the Depository Trust Company confirmations for four of the bonds reviewed.
- d) The Company did not list a number of insurance agencies in Schedule Y, Part 1, which conducted the business of insurance as listed under "AFFILIATED COMPANIES." The Company failed to include in its organizational chart SAFECO UK Limited and numerous insurance agencies which were owned either directly by SAFECO Corporation or by an affiliate. The NAIC Annual Statement Instructions indicate for Schedule Y, Part 1, that a chart or listing presenting the identities of and interrelationships between the parent, all affiliated insurers and other affiliates should be attached to the Annual Statement. RCW 48.01.050 defined an insurer as every person engaged in the business of making contracts of insurance. See comments under "AFFILIATED COMPANIES" of this Report of Examination.
- e) On February 9, 1996, the Company transferred a \$500,000 Indianapolis Gas Company bond to SAFECO Insurance Company of America, its parent. The transfer was not reported in Schedule Y, Part 2 of the Company's 1996 Annual Statement.

3. Bonds – Amortization

The Company was requested to provide bond amortization schedules for selected securities. The individual amortization schedules provided by the Company did not agree with the amortization reported in Schedule D of the Company's 2000 Annual Statement. The Company explained that it used a tool in PAM (Portfolio Accounting Management System) to prepare the schedules of bond amortization and that the amortization schedules provided were a very simplified way of determining amortization and were not expected to tie to Schedule D which uses more complicated models, algorithms, etc. The Company did not provide individual bond amortization schedules that would tie to the amortization reported in Schedule D.

The Company is instructed to correct and maintain amortization schedules on individual investments that will tie to the amortization reported in Schedule D and is instructed to comply with RCW 48.12.170(1)(b) which provides that bonds or evidences of debt having a fixed term and rate purchased above or below par shall be valued on the basis of the purchase price adjusted so as to bring the value to par at the earliest date callable at par or maturing at par or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner.

4. Short-Term Investment Not Confirmed

The JP Morgan – Prime Money Market Fund reported as having no CUSIP number and an admitted value of \$127,437 in Schedule DA, Part 1 of the Company's 2000 Annual Statement was not confirmed by the custodian, BNY Western Trust Company. No confirmation of the asset was made during the examination in spite of written requests by the examiners and telephone requests by the Company's cash management manager. The \$127,437 admitted value has been non-admitted on the financial statements of this report.

The Company is instructed to comply with RCW 48.12.010 that provides in any determination of the financial condition of any insurer there shall be allowed as assets only such assets as belong wholly and exclusively to the insurer, which are registered, recorded, or held under the insurer's name.

5. Receivable from Parent - Excess Loan

The Company's December 31, 2000 Annual Statement reported a \$7,344,255 admitted asset for "Receivable from Parent, Subsidiaries and Affiliates". The asset consisted of a \$7,355,000 receivable from SAFECO Insurance Company of America and a \$10,745 payable to another affiliate.

The SAFECO Group pooled temporary excess funds and invested these funds with institutional borrowers. The pooling of the funds resulted in a loan to the "lead" company and were booked as intercompany receivables and payables.

The \$7,355,000 loan to SAFECO Insurance Company of America exceeded the limit prescribed by the Washington Insurer Holding Company Act, RCW 48.31B.030(1)(b)(i)(A) which limited the amount of a loan to a non-life insurer to the lesser of 3% of the Company's prior year's admitted assets or 25% of surplus as regards to policyholders. As of December 31, 1999, the Company had \$24,699,455 in admitted assets and as of December 31, 2000 the Company had \$25,959,254 in surplus as regards policyholders. Based on the lesser limitation of 3% of the Company's admitted assets, the Company's maximum allowable loan was \$740,984 as of December 31, 2000. The \$7,355,000 loan was \$6,614,016 more than the \$740,984 limitation.

As of December 31, 1999, the Company had a similar receivable of \$5,022,916 from SAFECO Insurance Company of America. Based on the Company's December 31, 1998 admitted assets of \$23,368,718, this loan was \$4,321,854 more than the \$701,062 limitation (3% of the Company's prior year's admitted assets).

The Company is instructed to comply with RCW 48.31B.030(1)(b)(i)(A) which requires prior approval of intercompany transactions which exceed 3% of the Company's prior year's admitted assets. Further, the Company is given notice to cease and desist activity which violates Chapter 48.31B and is given notice of and is subject to applicable remedies contained in RCW 48.31B.050. The remedies and penalties under the Code do not provide for nonadmission of the asset, only cease and desist, avoidance of the transactions and possible monetary penalties.

6. Safekeeping of Securities

As of December 31, 2000, the Company had a September 22, 1995 custodial agreement with BankAmerica State Trust Company, as authorized agent for Seattle-First National Bank. A September 22, 1995 letter from The Bank of New York indicated that a corporate custody agreement dated July 13, 1987 between the SAFECO companies and BankAmerica Corporation was being assigned to BNY Western Trust Company. The 1995 letter was incorrect in that it should have referred to the 1995 agreement rather the 1987 agreement. During the examination the Company entered into a new custody agreement with BNY Western Trust Company, a subsidiary of The Bank of New York Company, Inc., dated July 23, 2001. The 2001 agreement was amended by the Company and the bank on August 23, 2001 in order to comply with the NAIC guidelines.

The Company is instructed to use due care and diligence in the tracking and oversight of custodial arrangements entered into in order to comply with RCW 48.05.280 and WAC 284-07-050(2) which requires the Company to keep full and adequate accounts and records of its affairs and to maintain compliance with NAIC guidelines.

7. Incomplete Finance Committee Minutes

Quarterly minutes of the Company's Finance Committee covering the period from January 1, 1996 through December 31, 2000 were incomplete as the Company was unable to locate the August 5, 1996 or the February 2, 1998 Finance Committee minutes.

On February 9, 1996, the Company transferred a \$500,000 Indianapolis Gas Company bond to SAFECO Insurance Company of America, its parent. The transfer was not included in the Company's Finance Committee minutes.

The Company is instructed to comply with RCW 48.13.340 which provides that no investment, sale or exchange shall be made by any domestic company unless authorized or approved by its Board of Directors or by a committee charged by the Board of Directors or the Bylaws with the duty of making such investment, sale or exchange and with RCW 48.05.280 which provides that every insurer shall keep full and adequate accounts and records of its assets, obligations, transactions and affairs.

COMMENTS AND RECOMMENDATIONS

The examination developed the following comments and recommendations:

1. Investment Guidelines

The investment guidelines adopted by the Company on May 1, 2000 covered both the SAFECO Group of life companies and the SAFECO Group of property and casualty companies on a

consolidated basis. Both the 2000 and 2001 investment guidelines had paragraphs that were incorrectly numbered or incomplete.

The Company adopted new investment guidelines effective January 1, 2002 that were correctly numbered; however, these guidelines were also on a consolidated basis for the life and property/casualty companies in the SAFECO Group. Before the January 1, 2002 investment guidelines were adopted, it was suggested to the Company that they be prepared on an individual company basis rather than on a consolidated basis. The consolidated guidelines adopted in 2002 currently cover the SAFECO Group of companies that are domiciled in a number of different states and have different limitations for various assets. An example of the investment limitations on an individual company basis are contained in RCW 48.13.180 and RCW 48.13.273.

It is recommended the Company adopt individual investment guidelines that cover the investment requirements in the Washington Insurance Code.

HISTORY

SAFECO Surplus Lines Insurance Company was incorporated August 25, 1983 under the laws of the state of Washington and began active operations on January 1, 1984.

CAPITAL AND SURPLUS

As of December 31, 2000, the authorized capital stock of the Company consisted of 20,000 shares of common stock with a par value of \$250 per share, of which 20,000 shares were issued and outstanding. The following schedule summarizes the changes in the Company's capital and paid in surplus since the date of the last examination:

<u>Date</u>	Authorized and Outstanding <u>Shares</u>	<u>Par Value</u>	<u>Capital Paid-Up</u>	<u>Paid In and Contributed Surplus</u>
December 31, 1995	20,000	\$205	\$4,100,000	\$6,550,000
December 31, 2000	20,000	250	5,000,000	5,650,000

On April 8 1999, Article V of the Company's articles of incorporation was amended to increase the par value of the Company's 20,000 shares of authorized common stock from \$205 to \$250 a share and to increase the Company's paid in capital from \$4,100,000 to \$5,000,000. The \$900,000 increase in capital paid-up was accomplished by transferring \$900,000 from the Company's paid in and contributed surplus. The \$900,000 transfer reduced the Company's paid in and contributed surplus from \$6,550,000 to \$5,650,000. The amendment was filed with the OIC on April 23, 1999 and was filed with the Washington Secretary of State on April 30, 1999.

Dividends

The Company paid no dividends to its shareholder or policyholders during the five-year period under review.

MANAGEMENT AND CONTROL

Shareholder

The Company's outstanding shares were 100% owned by SAFECO Insurance Company of America, an insurance company incorporated under the laws of the state of Washington. SAFECO Insurance Company of America was a wholly-owned subsidiary of SAFECO Corporation, an insurance holding company incorporated under the laws of the state of Washington.

SAFECO Corporation, directly or indirectly, owned the stocks of operating subsidiaries engaged in various phases of the insurance business and other financially related lines of business.

Directors

The affairs of the Company were managed and its corporate powers were exercised by the authority of a nine member Board of Directors. The membership of the Board as of December 31, 2000, together with the city and state of residence and principal business or professional affiliation of each director, were as follows:

<u>Name/Address</u>	<u>Position(s)/Principal Affiliation(s)</u>
Donald Shelton Chapman Woodinville, Washington	Senior Vice President, Chief Operating Officer SAFECO Insurance Company of America (Commercial Insurance)
Boh Andrew Dickey Woodinville, Washington	President and Chief Operating Officer SAFECO Corporation
Roger Harry Eigsti Seattle, Washington	Chairman and Chief Executive Officer SAFECO Corporation
Dale Ellis Lauer Woodinville, Washington	Senior Vice President SAFECO Insurance Company of America (American States Business Insurance)
William Thomas Lebo Lake Forest Park, Washington	Executive Vice President SAFECO Insurance Company of America

Directors, Cont'd

<u>Name/Address</u>	<u>Position(s)/Principal Affiliation(s)</u>
Rodney Allen Pierson Redmond, Washington	Senior Vice President, Chief Financial Officer, Secretary SAFECO Corporation
James Walter Ruddy Mercer Island, Washington	Senior Vice President, General Counsel SAFECO Corporation
Ronald Lee Spaulding Mill Creek, Washington	Treasurer and Chief Investment Officer SAFECO Corporation
Randall Howard Talbot Medina, Washington	President SAFECO Life Insurance Company

During January 2001, Roger Harry Eigsti and Boh Andrew Dickey resigned from the Board of Directors and Roger Floyd Harbin and Michael Sean McGavick were elected to the Board of Directors.

Officers

Officers of the Company as of December 31, 2000 were:

<u>Name</u>	<u>Position</u>
Boh Andrew Dickey	President
Steven Conrad Bauer	Treasurer
Rodney Allen Pierson	Secretary and Vice President
Richard Robert Berls	Vice President
Donald Shelton Chapman	Vice President
Peter Edward Dunn	Vice President
Dale Ellis Lauer	Vice President
William Thomas Lebo	Vice President
James Arthur Schmidt	Vice President
Robert Clark Taylor	Vice President
William Edward Thomas	Vice President

Effective January 30, 2001, Boh Andrew Dickey resigned as president of the Company and Michael Sean McGavick was appointed as president.

Finance Committee

The Company's Finance Committee consisted of the following members as of December 31, 2000:

Roger Harry Eigsti – Chairman
Boh Andrew Dickey
Rodney Allen Pierson
Ronald Lee Spaulding

During January 2001, Roger Harry Eigsti and Boh Andrew Dickey resigned from the Finance Committee and Michael Sean McGavick was appointed as a member of the Finance Committee. The number of members on the Finance Committee was reduced from four to three members.

CONFLICT OF INTEREST

The Company had an operating procedure for disclosing conflicts of interest to the Board of Directors. Statements are circulated among the directors, officers and key employees every year as set forth in the Company's Policy of Ethical Standards, Conflicts of Interest and Compliance with Laws. The Company had a procedure for obtaining disclosure statements from new appointees during the interim.

A review of the completed statements disclosed that the directors, officers and key employees had no conflicts of interest as of December 31, 2000.

AFFILIATED COMPANIES

The Company was a wholly-owned subsidiary of SAFECO Insurance Company of America. SAFECO Corporation was the ultimate controlling person. As a member of an Insurance Holding Company System, registration statements were required to be filed in accordance with RCW 48.31B.025 and WAC 284-18-300. SAFECO Corporation filed the registration statements for each year under examination on behalf of the Company, its parent company and its affiliated companies.

The following chart was taken from the SAFECO Corporation Organizational and Entity Chart:

SAFECO Corporation	100% Publicly Owned
SAFECO Financial Products, Inc.	100% SAFECO Corporation
SAFECO Insurance Company of Oregon	100% SAFECO Corporation
General America Corporation	100% SAFECO Corporation
Talbot Financial Corporation	100% General America Corporation
F. B. Beattie & Co., Inc.	100% General America Corporation
SAFECO Investment Services, Inc.	100% General America Corporation
SAFECO Select Insurance Services, Inc.	100% General America Corporation
R. F. Bailey Holding Limited	100% General America Corporation

AFFILIATED COMPANIES, Cont'd

General America Corporation of Texas – Attorney in Fact for:	100% General America Corporation
SAFECO Lloyds Insurance Company	Attorney in Fact
American States Lloyds Insurance Company	Attorney in Fact
First National Insurance Company of America	100% SAFECO Corporation
SAFECO Insurance Company of America	100% SAFECO Corporation
SAFECO Management Corporation	100% SAFECO Insurance Company of America
SAFECO Surplus Lines Insurance Company	100% SAFECO Insurance Company of America
Emerald City Insurance Agency, Inc.	100% SAFECO Insurance Company of America
SAFECO National Insurance Company (Missouri)	100% SAFECO Corporation
General Insurance Company of America	100% SAFECO Corporation
SAFECO Insurance Company of Pennsylvania	100% General Insurance Company of America
SAFECO Insurance Company of Illinois	100% SAFECO Corporation
Insurance Company of Illinois	100% SAFECO Insurance Company of Illinois
American States Insurance Company (Indiana)	100% SAFECO Corporation
American Economy Insurance Company (Indiana)	100% SAFECO Corporation
American States Insurance Company of Texas	100% American Economy Insurance Company
American States Preferred Insurance Company (Indiana)	100% SAFECO Corporation
SAFECO Credit Company Inc.	100% SAFECO Corporation
SAFECO Properties, Inc.	100% SAFECO Corporation
Winmar Company, Inc.	100% SAFECO Properties, Inc.
SAFECARE Company, Inc.	100% SAFECO Properties, Inc.
SAFECO Life Insurance Company	100% SAFECO Corporation
SAFECO National Life Insurance Company	100% SAFECO Life Insurance Company
American States Life Insurance Company	100% SAFECO Life Insurance Company
First SAFECO National Life Insurance Company of New York	100% SAFECO Life Insurance Company
D. W. Van Dyke & Co., Inc.	100% SAFECO Life Insurance Company
Medical Risk Managers, Inc.	15% SAFECO Life Insurance Company 85% D. W. Van Dyke & Co., Inc.
SAFECO Asset Management Company	100% SAFECO Corporation
Barrier Ridge LLC	100% SAFECO Corporation
SAFECO Services Corporation	100% SAFECO Corporation
SAFECO Securities, Inc.	100% SAFECO Corporation
SAFECO eCommerce, Inc.	100% SAFECO Corporation
SAFECO Trust Company	100% SAFECO Corporation
SAFECO UK Limited	100% SAFECO Corporation
SAFECO Administrative Services, Inc.	100% SAFECO Corporation
SAFECO Assigned Benefits Service Company	100% SAFECO Corporation

The Company failed to include in its organizational chart numerous insurance agencies which were owned either directly by SAFECO Corporation or by an affiliate. The NAIC Annual Statement Instructions indicate for Schedule Y, Part 1, that a chart or listing presenting the identities of and interrelationships between the parent, all affiliated insurers and other affiliates should be attached to the Annual Statement. RCW 48.01.050 defined an insurer as every person engaged in the business of making contracts of insurance. The Company did not list the

following insurance agencies in Schedule Y, Part 1 (shown below with the parent company relationship):

- SAFECO Insurance Company of America
 - Emerald City Insurance Agency, Inc.
 - Puget Structured Benefit Agency, Inc.
- SAFECO Select Insurance Services, Inc.
- Pilot Insurance Services, Inc.
- Talbot Agency, Inc.
 - Talbot Financial Services, Inc.
 - Talbot Insurance Agency of Alabama, Inc.
 - Talbot Insurance Agency of Texas, Inc.
 - Talbot Agency of Texas, Inc.
- General America Corporation
 - F. B. Beattie & Company, Inc.
 - F. B. Beattie Insurance Services, Inc.
 - R. F. Bailey Holding Limited
 - R. F. Bailey (Underwriting Services) Limited
- SAFECO Life Insurance Company
 - D. W. Van Dyke & Co., Inc.
 - Medical Risk Managers, Inc.

CORPORATE RECORDS

On April 8, 1999, the Company's original Articles of Incorporation were amended and restated by the Company's sole shareholder. The changes in the Company's Articles of Incorporation included the following:

Article I of the Articles of Incorporation was deleted in its entirety and the remaining Articles were renumbered accordingly.

Article VI of the Articles of Incorporation was renumbered Article V and was amended in its entirety to read, "The amount of capital stock shall be Five Million Dollars (\$5,000,000) and the number of shares shall be Twenty Thousand (20,000) and the par value of each of said shares shall be \$250."

Article VIII of the Articles of Incorporation was renumbered Article VII and was amended in its entirety to read, "The number of directors of this corporation shall be fixed as provided in its Bylaws, and may be changed from time to time pursuant to the Bylaws or by amending the Bylaws as therein provided, but the number thereof shall never be less than five (5) nor more than thirty (30)."

The amended and restated Articles of Incorporation were filed with the OIC on April 23, 1999 and were filed with the Washington Secretary of State on April 30, 1999.

Minutes

The minutes of the Shareholder, Board of Directors and Finance Committee meetings for the period covered under examination were reviewed. Investments were reviewed by the Finance Committee and the Finance Committee minutes were ratified by the Board of Directors; however, the minutes for two quarterly Finance Committee meetings were not located by the Company during the examination.

Contracts/Service Agreements

The following agreements were in force as of December 31, 2000:

1. Intercompany tax allocation agreement dated August 1, 1990. A consolidated return was filed by SAFECO Corporation with the companies included in Schedule Y of the Annual Statement in which there was an 80% or more ownership, except for American States Life Insurance Company. The allocation was based upon separate return calculations with current credit for net losses as such losses offset taxable income of other members of the consolidated group. Intercompany tax balances were settled quarterly.
2. A Short-Term Borrowing Agreement dated October 27, 1997 between the Company, as lender, and SAFECO Credit Company, Inc., as borrower.
3. The Company and twenty other affiliated companies in the SAFECO Group were named in an Intercompany Short-Term Borrowing Agreement effective November 15, 2000.
4. Expense Sharing Agreement dated November 3, 1983. The Agreement covers Payroll, use of real property, and miscellaneous expenses for sixteen stock companies within the Safeco Group, which includes the six Washington domestic insurance companies. All of the companies are 100%-owned direct or indirect subsidiaries of Safeco Corporation, the ultimate controlling person in the Safeco holding company system.

Intercompany Agreements should be used to document recurring transaction patterns between or among the SAFECO Group member companies. RCW 48.31B.030(1)(a)(iv), requires that records are to "...clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees..." An extensive volume of investment transactions were conducted between the SAFECO insurance companies and SAFECO Asset Management Company, but there was no intercompany agreement specifying the parties' rights, duties and compensation. All such agreements are required to be filed and approved by the OIC. See item 1 under the "INSTRUCTIONS" portion of this Examination Report.

FIDELITY BONDS AND OTHER INSURANCE

The Company's fidelity insurance was extended to affiliated companies through a Financial Institution Bond issued to SAFECO Corporation which provided coverage up to \$3,000,000 aggregate with no deductible. The companies carry excess insurance which provided an additional amount of coverage in layers through several carriers. The minimum amount of fidelity insurance coverage recommended by the NAIC for a company of this size is \$400,000 to \$450,000. This minimum amount was met with the Financial Institution Bond and the excess insurance.

The Company was a named insured on various insurance policies issued to SAFECO Corporation that provided protection against certain property and liability losses. Policies providing property coverage for buildings and contents, comprehensive commercial general liability and automobile bodily injury and property damage coverage were in effect during the period covered by this examination.

The Company was a named insured on a Directors and Officers Liability Policy with an authorized insurance carrier. Errors and Omissions coverage was also provided under this policy.

OFFICERS', EMPLOYEES', AND AGENTS' WELFARE AND PENSION PLANS

The employees of the SAFECO Group of property/casualty and life companies were treated as employees of SAFECO Insurance Company of America. The salaries and benefits paid or accrued to these employees were allocated and prorated to the various companies in the Group based on the intercompany pooling agreement and other intercompany arrangements.

The SAFECO Group had the following benefit plans available to officers, employees and their dependents: Group Life Insurance, Accidental Death and Dismemberment, Long-term Disability, Medical and Dental. The SAFECO Group contributes to the Life, Medical and Dental plans.

The SAFECO Group had the following retirement and profit sharing plans:

- 1. Cash Balance Plan** – A defined contribution plan established during 1989. The plan provided an annual credit to each employee's account, regardless of profitability of the SAFECO Group. The amount was 3% of eligible compensation paid each year to the participants. The participant's balances were credited with interest at a rate of 5%.
- 2. Profit Sharing Bonus** – A cash bonus was paid to the salaried employees who had completed one calendar year of service. Each year 10% of the "adjusted underwriting profit" of the SAFECO Group earned during the previous year was allocated to the profit sharing bonus plan. A cash bonus was then paid to the eligible employees based on a percentage of the previous year's base salary. An employee with three or more calendar years of service could receive a maximum cash bonus of 10% of his or her previous year's salary.

3. **Profit Sharing Retirement Plan** – A defined contribution plan in which contributions are based on the SAFECO Group's profit, 5% of net profit, before taxes and stockholder's dividends and after subtracting an amount credited to the Cash Balance Plan. The maximum contribution to the trust shall not exceed 12% of eligible compensation paid each year to the participants.
4. **Employees' Savings Plan** – A defined contribution plan was established during 1967. The plan was available to an employee after 12 calendar months of service. An employee could save up to 6% of basic salary. The companies contributed an amount equal to two-thirds of the employee's deduction.

SAFECO Corporation had a stock option plan for executives and key employees. The stock was issued in SAFECO Corporation. In addition, two non-qualified benefit plans were established during 1989 for the companies' contributions to the Profit Sharing Retirement Plan in excess of the amounts allowed by the Internal Revenue Service.

The Company had a separate plan available for its independent agents and agencies. The plan was 100% funded by the agents and agencies and included Group Life, Accidental Death and Dismemberment and Long-Term Disability.

TERRITORY AND PLAN OF OPERATION

The Company was admitted only in Washington and therefore, wrote excess and surplus lines business in all states except Washington, as surplus lines business may be written only with non-admitted companies. The direct business written by the Company is ceded 100% to SAFECO Insurance Company of America under an intercompany pooling agreement.

The Company's direct writings consisted of fire, allied lines, commercial multiple peril, inland marine, medical malpractice, earthquake, worker's compensation, other liability, burglary and theft and boiler and machinery.

The companies within the SAFECO Insurance Group operate within the independent agency system. They provide both personal and commercial property and casualty markets and are divided into two enterprise units for operational ease; SAFECO Business Insurance and SAFECO Personal Insurance. The business enterprise has five regional offices (Redmond, WA, Fountain Valley, CA, Richardson, TX, Indianapolis, IN, and Atlanta, GA) while the personal enterprise has two regional offices (Redmond, WA and Atlanta, GA). Appropriate claims offices are maintained throughout the United States to provide effective and efficient service to claimants.

GROWTH OF COMPANY

The growth of the Company for the past five years is reflected in the following exhibit (000's omitted) prepared from copies of the filed annual statements:

<u>Year</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Capital</u>	<u>Surplus</u>	<u>Premiums Earned</u>
2000	\$26,031	\$72	\$5,000	\$20,959	\$0
1999	24,699	42	5,000	19,657	0
1998	23,369	85	4,100	19,184	0
1997	21,975	49	4,100	17,826	0
1996	20,758	77	4,100	16,581	0

REINSURANCE

Intercompany Pooling Agreement

The Company had entered into an intercompany reinsurance agreement whereby SAFECO Insurance Company of America, the Company's parent, assumed 100% of the direct business written by the Company and assumed 100% of the direct business written and assumed by 13 other affiliated companies. The direct business written by SAFECO Insurance Company of America and the business assumed from the 14 affiliated companies was pooled. The parent company arranged for excess and catastrophe reinsurance with nonaffiliated companies, as needed. The pooled business was retroceded to the following companies in the percentages stated below:

SAFECO Insurance Company of America	33%
General Insurance Company of America	23%
First National Insurance Company of America	2%
SAFECO National Insurance Company	2%
SAFECO Insurance Company of Illinois	5%
American States Insurance Company	19%
American States Preferred Insurance Company	2%
American Economy Insurance Company	14%
SAFECO Lloyds Insurance Company	0%
SAFECO Insurance Company of Pennsylvania	0%
SAFECO Insurance Company of Oregon	0%
SAFECO Surplus Lines Insurance Company	0%
Insurance Company of Illinois	0%
American States Insurance Company of Texas	0%
American States Lloyds Insurance Company	0%
Total	<u>100%</u>

As of December 31, 2000, the Company had \$44,674,000 in aggregate unsecured amounts recoverable from SAFECO Insurance Company of America.

ACCOUNTS AND RECORDS

The external audit firm of Ernst and Young LLP was retained by the Company to audit the Company's statutory financial statements for the years under examination. Reports for 1999 and 2000 were provided as well as the work papers for 2000. As part of the audit work papers, the internal control structure noted deficiencies in the timely preparation of bank reconciliations and the clearance of items listed on the reconciliations.

The Internal Audit Department of the parent company, SAFECO Corporation, performed audits of the Company and provided recommendations to management on internal controls and operational procedures.

The Examiners independently tested internal controls and the following significant weaknesses were found:

General Ledger Control (GLC) Accounts – Reconciliations between the general ledger and subsidiary records for a number of accounts, including cash, were centrally maintained for most SAFECO companies by one department, GLC. GLC identified differences between the general and subsidiary accounts and referred the specific items (variances) to the originating SAFECO department for investigation and potential correction. During the five-year period under examination, there were numerous variances that were not cleared but were continuously outstanding. This resulted from a lack of consistent accounting discipline and control and appropriate management guidance to clear variances on a timely basis. In mid-2002, the SAFECO Group of companies began the implementation of a new, stronger control process to ensure account accuracy and to control timely reconciliation of accounts.

During the examination, the Company engaged an external firm to guide and oversee resolving the many cash and other account reconciliations that had been in process for years and to put in place new procedures and controls.

Electronic Data Processing System

The management of the Company had sufficient knowledge of electronic data processing issues and provided direction and oversight through its Business Application Groups. Systems development, acquisition and maintenance controls were evaluated to gain assurance that programs and systems were designed, tested, approved and implemented using appropriate controls. The internal controls in place provided for the proper separation of duties.

Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed and the controls exercised to maintain data security. Adequate procedures and controls were in place for mainframe and network operations.

CONTINGENT LIABILITIES AND LEASES

The Company had no material contingent liabilities or leases as of December 31, 2000.

SUBSEQUENT EVENTS

1. The NAIC adopted Statements of Statutory Accounting Principles (Codification) effective January 1, 2001. The effect of Codification resulted in a \$93,712 decrease in the Company's 2001 statutory surplus.
2. On November 8, 2001, the Company's Bylaws were amended to revise the Regular Meeting verbiage. The reference to a specific meeting date each quarter was removed and replaced with wording that requires a quarterly meeting on a date and place to be specified. This amendment was made to allow the Board of Directors more flexibility and places the Company's bylaws in compliance with the other insurance companies within the SAFECO Group.

FINANCIAL STATEMENTS

The following statements, with the exception of the Five Year Reconciliation of Capital and Surplus as stated by the Company, reflect the financial condition of the Company as of December 31, 2000, as determined by this examination:

Balance Sheet
As of December 31, 2000

Statement of Income
Year Ended December 31, 2000

Capital and Surplus Account
As of December 31, 2000

Reconciliation of Capital and Surplus Account
For the Five Year Examination Period (Per Company)

Comparative Analysis of Changes of Surplus
As of December 31, 2000

SAFECO SURPLUS LINES INSURANCE COMPANY
Balance Sheet
As of December 31, 2000

	<u>BALANCE PER COMPANY</u>	<u>NOTES</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
<u>ASSETS</u>				
Bonds	\$ 18,214,583		\$ -	\$ 18,214,583
Cash and short-term investments	<u>143,588</u>	1	<u>(127,437)</u>	<u>16,151</u>
Subtotals, cash and invested assets	\$ 18,358,171		\$ (127,437)	\$ 18,230,734
Interest, dividends and real estate income due and accrued	328,762			328,762
Receivable from parent, subsidiaries and affiliates	<u>7,344,255</u>		<u>-</u>	<u>7,344,255</u>
Total Assets	<u>\$ 26,031,188</u>		<u>\$ (127,437)</u>	<u>\$ 25,903,751</u>
<u>LIABILITIES</u>				
Federal and foreign income taxes (excluding deferred taxes)	\$ <u>71,934</u>		\$ -	\$ <u>71,934</u>
Total Liabilities	<u>\$ 71,934</u>			<u>\$ 71,934</u>
<u>SURPLUS AND OTHER FUNDS</u>				
Common capital stock	\$ 5,000,000		\$ -	\$ 5,000,000
Gross paid in and contributed surplus	5,650,000			5,650,000
Unassigned funds (surplus)	<u>15,309,254</u>		<u>(127,437)</u>	<u>15,181,817</u>
Surplus as regards policyholders	\$ <u>25,959,254</u>		<u>\$ (127,437)</u>	<u>\$ 25,831,817</u>
Total Liabilities, Surplus and Other Funds	<u>\$ 26,031,188</u>		<u>\$ (127,437)</u>	<u>\$ 25,903,751</u>

SAFECO SURPLUS LINES INSURANCE COMPANY
Statement of Income
For the Year Ended December 31, 2000

	<u>BALANCE PER COMPANY</u>	<u>NOTES</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
<u>UNDERWRITING INCOME</u>				
Premiums earned	\$ -		\$ -	\$ -
DEDUCTIONS:	\$ -		\$ -	\$ -
Losses incurred				
Loss expenses incurred				
Other underwriting expenses incurred	-		-	-
Total underwriting deductions	\$ -		\$ -	\$ -
Net underwriting gain or (loss)	\$ -		\$ -	\$ -
Net investment income earned	\$ 1,553,416		\$ -	\$ 1,553,416
Net realized capital gains or (losses)	22,410		-	22,410
Net investment gain or (loss)	\$ 1,575,826		\$ -	\$ 1,575,826
<u>OTHER INCOME</u>				
Finance and service charges not included in premiums	\$ -		\$ -	\$ -
Aggregate write-ins for miscellaneous income	-		-	-
Total other income	\$ -		\$ -	\$ -
Net income before dividends to policyholders and before federal and foreign income taxes	\$ 1,575,826		\$ -	\$ 1,575,826
Dividends to policyholders	-		-	-
Net income after dividends to policyholders but before federal and foreign income taxes	\$ 1,575,826		\$ -	\$ 1,575,826
Federal and foreign income taxes incurred	273,933		-	273,933
Net Income	\$ 1,301,893		\$ -	\$ 1,301,893

SAFECO SURPLUS LINES INSURANCE COMPANY
Capital and Surplus Account
As of December 31, 2000

	<u>BALANCE PER COMPANY</u>	<u>NOTES</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
Surplus as Regards Policyholders, December 31 Prior Year	<u>\$ 24,657,361</u>		<u>\$ -</u>	<u>\$ 24,657,361</u>
<u>GAINS AND (LOSSES) IN SURPLUS</u>				
Net income	\$ 1,301,893		\$ -	\$ 1,301,893
Net unrealized capital gains or (losses)		1	(127,437)	(127,437)
Change in non-admitted assets				
Change in provision for reinsurance				
Change in excess of statutory reserves over statement reserves				
Aggregate write-ins for gains and losses in surplus	<u>-</u>		<u>-</u>	<u>-</u>
Change in surplus as regards policyholders for the year	<u>\$ 1,301,893</u>		<u>\$ (127,437)</u>	<u>\$ 1,174,456</u>
Surplus as Regards Policyholders, December 31 Current Year	<u>\$ 25,959,254</u>		<u>\$ (127,437)</u>	<u>\$ 25,831,817</u>

SAFECO SURPLUS LINES INSURANCE COMPANY
Reconciliation of Capital and Surplus Account
For the Five Year Examination Period
(Per Company)

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Surplus as Regards Policyholders, December 31 Prior Year	\$ 24,657,361	\$ 23,283,380	\$ 21,926,045	\$ 20,680,959	\$ 19,485,977
GAINS AND (LOSSES) IN SURPLUS:					
Net Income	\$ 1,301,893	\$ 1,373,981	\$ 1,357,335	\$ 1,245,086	\$ 1,194,982
Net unrealized capital gains or (losses)					
Change in non-admitted assets					
Change in provision for reinsurance					
Change in excess of statutory reserves over statement reserves					
Capital changes:					
Paid in		900,000			
Surplus adjustments:					
Paid in	-	(900,000)	-	-	-
Change in surplus as regards policyholders for the year	\$ 1,301,893	\$ 1,373,981	\$ 1,357,335	\$ 1,245,086	\$ 1,194,982
Surplus as Regards Policyholders, December 31 Current Year	\$ 25,959,254	\$ 24,657,361	\$ 23,283,380	\$ 21,926,045	\$ 20,680,959

SAFECO SURPLUS LINES INSURANCE COMPANY
Comparative Analysis of Changes in Surplus
As of December 31, 2000

The following is a reconciliation of surplus as regards policyholders between that reported by the Company and determined by the examination:

	PER <u>COMPANY</u>	PER <u>EXAMINATION</u>	<u>NOTES</u>	INCREASE (DECREASE) <u>IN SURPLUS</u>	<u>TOTALS</u>
Capital and surplus, December 31, 2000 - Per Annual Statement					\$ 25,959,254
<u>ASSETS</u>					
Cash and short-term investments	\$ 143,588	\$ 16,151	1	\$ (127,437)	
Change in surplus					\$ (127,437)
Capital and Surplus, December 31, 2000 - Per Examination					<u>\$ 25,831,817</u>

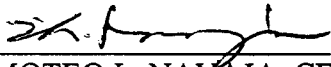
NOTES TO FINANCIAL STATEMENTS

1. The JP Morgan – Prime Money Market Fund reported as having no CUSIP number and an admitted value of \$127,437 in Schedule DA, Part 1 of the Company's 2000 Annual Statement was not confirmed by the custodian, BNY Western Trust Company. No confirmation of the asset was made as of December 31, 2000 in spite of written requests by the Examiners and telephone requests by the Company's cash management manager. The \$127,437 admitted value has been not admitted on the financial statements of this report. The Company is instructed to comply with RCW 48.12.010 that provides in any determination of the financial condition of any insurer there shall be allowed as assets only such assets as belong wholly and exclusively to the insurer, which are registered, recorded, or held under the insurer's name. See "INSTRUCTIONS" No. 4, Short-Term Investment Not Confirmed.

ACKNOWLEDGEMENT

Examiners John J. Gaynard, CPA, CPCU, AFE; Peter M. Mendoza, CFE, CIE; Orlando R. Gabriel, Kehinde Ovbiebo, Constantine Arustamian, CPA; Mike Bosley, CPA; Charles J. Mitchell, CPA; Mitch Coe, CPA; Michael V. Jordan, CPA, CFE, MHP, Assistant Chief Examiner, Eric Slavich, Actuarial Analyst 2, and D. Lee Barclay, FCAS, MAAA, Senior Actuary, from the Washington State Office of Insurance Commissioner, and Richard A. Randour, CFE, CPA, from the State of Delaware participated in the examination and preparation of this report.

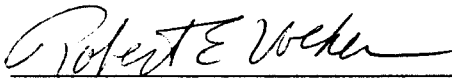
Respectfully submitted,



TIMOTEO L. NAVAJA, CFE, CIE
Examiner-in-Charge
Office of Insurance Commissioner
State of Washington



LARRY E. CROSS, CFE, CIE
Insurance Examiner
Representing Delaware
and NAIC Northeastern Zone




ROBERT E. VOLKER, CFE, CIE
Insurance Examiner
Representing Nevada
and NAIC Western Zone

AFFIDAVIT

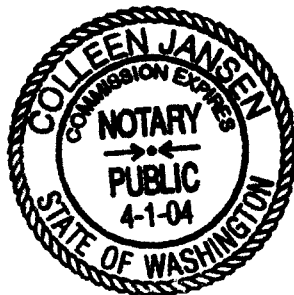
STATE OF WASHINGTON)
) ss
COUNTY OF KING)

Timoteo L. Navaja, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

He attests that the examination of SAFECO Surplus Lines Insurance Company was performed in a manner consistent with the standards and procedures required or prescribed by the Washington State Office of Insurance Commissioner and the National Association of Insurance Commissioners (NAIC).


TIMOTEO L. NAVA, CFE, CIE
Examiner-in-Charge

Subscribed and sworn to before me on this 11th day of September, 2003.



Colleen Jansen
Notary Public in and for the
State of Washington,
residing at Seattle
My commission expires 4/1/04